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Outlook for the Economy and Real Estate

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The Outlook for the Economy and Real Estate

GNP-Growth - Mostly Inventory Building

The latest estimate of the real GNP growth rate (4.3 percent) seems to suggest another step forward in the current economic expansion. However, a more accurate assessment would be that the economy is "muddling through" the late years of a 4 year old expansion. Most of the growth increase was due to higher levels of U.S. manufacturing production; certainly a good sign. Countering this good news was the fact that most of this production ended up as inventory because consumer demand for these items had fallen off the past two quarters. Besides this recent spate of inventory building, real net exports was the only other major component in the U.S. economy to contribute positively to GNP growth. The other sectors of the economy -- business fixed investment, consumption, residential construction, and government purchases -- declined during the first quarter. This is an important signal because these core sectors are the real "guts" behind any sustained expansion. In the current quarter, the growth rate of real GNP should slow to 1.2 percent because weak inventory investment will offset the consumption rebound, and real net exports will lose some steam because of an expected rise in oil imports. For all of 1987, the rate of growth in real GNP will likely be about 2.3 percent, followed by a similar 2.5 percent growth rate in 1988, as the mature expansion struggles to recover some of its lost vigor.

Consumption is expected to rebound for much of the same reason that it declined in the last two quarters — auto sales. Sales of automobiles surged in the third quarter of 1986 in response to a large sales incentives package. They continued at a robust pace in the fourth quarter because consumers moved up 1987 purchases into 1986 to take advantage of the doomed sales tax deduction. The "payback" for these advance purchases hit in the first quarter of 1987, and auto sales could resume at a healthy pace for the remainder of 1987, with some additional production perhaps devoted to building an inventory buffer in case of an auto workers strike.

Investment spending by businesses for structures dropped 21.0 percent in the first quarter, and equipment spending was off almost 10 percent from its fourth quarter level. Equipment spending has already suffered throughout 1986 because of the retroactive elimination of the investment tax credit by the new tax reform law, so 1987 should see new life in equipment spending. Investment spending on structures was also hit hard by the new tax law, but the recovery will not be as quick as that of equipment spending because high vacancy rates will hold back investment in new structures over the next couple years.

A New Import - Inflation?

It is very hard to reconcile the current weak state of the economy -- weak demand in the key sectors of consumption and business fixed investment -- with a new round of high inflation. Typically, high inflation rates are the result of an overheating economy in which wages and prices chase each other in a crippling upward spiral. This time around, higher inflation will likely enter the economy via higher import prices due to the weaker U.S. dollar. U.S. producers will then be able to raise their prices along with foreign importers, leading to a somewhat higher level of inflation during 1987. But without strong consumption and investment spending, wages will likely only rack up modest gains and consumer price inflaton will rise to only about 3.7 percent in 1987, up from 1.9 percent in 1986 and 3.0 percent in our March-April forecast. If the dollar decline continues modestly through 1988, helping to adjust the trade balance, inflation could rise to 4.2 percent in 1988, before falling below 4.0 percent in 1989.

What Will the Fed Do?

Whether these developments and emerging trends are actually borne out over the forecast interval will be determined in large part by the conduct of monetary policy. Federal Reserve Chairman Volcker has devoted his two terms to stamping out inflation while allowing reasonable economic growth. Odds are that he is not about to abandon his concern for inflation. Yet, the latest round of dollar depreciation in currency markets has caused increasing hesitancy among foreign investors who are considering purchasing and/or holding dollar-denominated assets. They fear that as the dollar falls in value, so will the value of their dollar-denominated investments. Interest-sensitive sectors of the U.S. economy, particularly the housing industry, have come to depend on net foreign capital inflows to finance investment and keep domestic interest rates lower than what they otherwise would be.

The Fed has responded to this crisis by allowing short term interest rates to rise in order to help stabilize the value of the dollar on world markets and to calm inflation fears. But despite the Fed's efforts at stabilizing the dollar, foreign investors' skepticism remains and has led them to demand higher yields on long-term U.S. investments. This has abruptly reversed the rally in the U.S. bond market and sent U.S. long term interest rates skyrocketing. The initial panic seems to have subsided, but long term rates remain very high relative to their levels of late March.

The hope is that this recent rise in long term rates represents more of an increase in inflationary expectations by investors and not actually a rise in the real interest rate (nominal interest rate minus inflation). An increase in real interest rates at this time of weak domestic demand could push the U.S. economy into a recessionary period of negative GNP growth rates. Instead, this forecast assumes that at least half of the long term rate rise was due to inflationary expectations, and that these expectations will erode back to previous levels producing a downward trend in long-term interest rates over the coming quarters.

Housing Markets

Existing Homes

The first quarter of 1987 ended on a very positive note for the real estate industry, as sales of existing single-family homes rose to an annual rate of 3.71 million units in March. This rate was a 0.5 percent increase over the February sales pace of 3.69 million units, and a 14.5 percent rise above the March 1986 sales rate. However, the prospects for the second quarter of 1987 are not quite as good, owing to the recent surge in long term interest rates. These rates are expected to trend downward throughout 1987, meaning that existing homes will still be sold at a robust pace of 3.49 million units, only slightly off from the 1986 sales rate of 3.56 million units. In 1988, sales of existing homes will be gaining momentum steadily and could post a sales rate of 3.68 million units for the year.

Housing Starts

Starts of single-family homes set a strong pace in the first quarter with an average annual rate of 1.27 million units--a rise of 3.3 percent over the first quarter of 1986, and stronger than any quarter in 1986. However, despite the strength of the single-family numbers, total housing starts fell to 1.77 million units in March, down from 1.89 million units in March 1986. The average annual rate

for total housing starts in the first quarter was 1.81 million units, down 6.7 percent from the 1.94 million unit rate of the first quarter of 1986. Total starts were pulled down by continued weakness in multi-family units. The first quarter average annual rate of 542 thousand units was virtually unchanged from the fourth quarter rate of 543 thousand units, and was 23.8 percent below the 711 thousand unit rate of the first quarter in 1986. Total housing starts are expected to decline to 1.66 million units in the current quarter because of the interest rate surge. The expected downward trend in long-term interest rates will touch off modest gains in housing starts, bringing total starts to a level of 1.68 million units for 1987, and 1.71 million units in 1988. Both single-family and multi-family starts will suffer from the rate rise, but single-family starts will rebound quickly to 1.21 million units in 1987, and 1.24 million units in 1988. Multi-family units will remain depressed because of the adverse impacts of the new tax law, reaching only 471 thousand units in 1987, and 477 thousand units in 1988.

Risks to the Forecast

Exactly how much inflation should be expected in 1987 is a subject of much debate because of the greenback's recent gyrations. Our forecast calls for a somewhat higher rate of inflation this year than last, but it is possible that prices could rise by as much as 5.0 percent this year. It should be stressed that we feel this is an unlikely scenario because the economy is fundamentally weak. But, if higher inflation were to materialize, it would probably come as a result of further sharp declines in the dollar that would lead to even higher import prices than in the present forecast, and touch off still higher expectations of inflation. What this means for the real estate industry is that faster inflation than assumed in this forecast would probably postpone the expected return of long term interest rates to their lower levels of earlier this year.

U.S. ECONOMIC OUTLOOK

	QUARTERS							YEARS				
	Actual		Forecast					Actual		Forecast		
	1986.4	1987.1	1987.2	1987.3	1987.4	1988.1	1988.2	1988.3	1985	1986	1987	1988	1989
AGGREGATE ECONOMY													
Gross National Product (billions of dollars)	4,259	4,339	4,390	4,443	4,515	4,584	4,656	4,726	3,998	4,206	4,422	4,693	4,994
% Change	1.7	7.8	4.8	4.9	6.7	6.2	6.5	6.2	6.2	5.2	5.1	6.1	6.4
% Change (w/out inflation)	1.1	4.3	1.2	1.4	3.2	2.2	2.8	2.7	2.7	2.5	2.3	2.5	2.8
Consumer Prices (CPI)	2.9	5.3	4.5	4.4	4.3	4.3	4.2	3.8	3.5	1.9	3.7	4.2	3.6
GNP Deflator	0.7	3.5	3.4	3.4	3.4	3.9	3.6	3.4	3.3	2.6	2.8	3.6	3.5
Unemployment Rate (%) (civilian)	6.8	6.7	6.7	6.8	6.8	6.9	6.8	6.8	7.2	7.0	6.7	6.8	6.6
Civilian Employment - Household Basis (millions)	110.4	111.3	111.6	112.0	112.4	112.7	113.1	113.5	107.2	109.6	111.8	113.3	114.9
% Change	1.6	3.3	1.1	1.4	1.4	1.1	1.4	1.4	2.0	2.3	2.0	1.3	1.4
Mfg. Capacity Utilization	79.8	79.9	79.3	78.8	79.0	79.0	79.2	79.4	80.3	79.7	79.2	79.3	80.0
Domestic Auto Sales	7.9	6.8	7.2	7.8	7.1	7.4	7.5	7.5	8.2	8.4	7.2	7.5	7.7
Federal Tax Receipts (NIPA)	855	854	879	891	912	910	928	945	787	827	884	937	997
% of GNP	20.1	19.7	20.0	20.1	20.2	19.8	19.9	20.0	19.7	19.7	20.0	20.0	20.0
Federal Expenditures (NIPA)	1,043	1,050	1,050	1,060	1,079	1,090	1,103	1,120	985	1,030	1,060	1,113	1,166
% of GNP	24.5	24.2	23.9	23.9	23.9	23.8	23.7	23.7	24.6	24.5	24.0	23.7	23.3
Deficit (NIPA)	-188.8	-196.0	-171.8	-169.3	-167.8	-180.7	-175.6	-175.2	-198.0	-203.4	-176.2	-176.6	-168.4
% of GNP	-4.4	-4.5	-3.9	-3.8	-3.7	-3.9	-3.8	-3.7	-4.9	-4.8	-4.0	-3.8	-3.4
REAL ESTATE MARKETS													
Total Single-Family Home Sales (single-family resales and completions, 1000)	4,855	4,851	4,502	4,589	4,700	4,730	4,876	4,905	4,255	4,717	4,660	4,883	5,062
Percent Change -- Year Ago	6.9	8.6	-3.6	-3.0	-3.2	-2.5	8.3	6.9	8.2	10.9	-1.2	4.8	3.7
Existing Single-Family Home Sales (1000)	3,890	3,623	3,356	3,447	3,532	3,578	3,677	3,705	3214	3565	3490	3684	3892
Percent Change -- Year Ago	6.6	10.2	-3.3	-4.8	-5.3	-1.2	9.6	7.5	12.1	10.9	-2.1	5.6	5.6
Housing Starts	1,702	1,808	1,663	1,604	1,638	1,628	1,707	1,723	1,742	1,819	1,678	1,713	1,750
% Change	-5.3	-6.7	-11.5	-8.8	-3.8	-10	2.6	7.4	-1.4	4.4	-7.8	2.1	2.2
Single-Family Units	1,159	1,266	1,181	1,177	1,204	1,188	1,236	1,237	1,073	1,188	1,207	1,236	1,206
% Change	5.6	3.2	-2.9	2.4	3.9	-6.1	4.6	5.1	-2.4	10.8	1.6	2.4	-2.5
Multi-Family Units	543.7	542.0	481.2	426.3	433.9	439.1	470.6	485.8	669.7	631.2	470.9	477.1	544.8
2-4 Family Units	88.0	78.3	77.9	69.0	70.3	71.1	76.2	78.6	93.4	85.4	73.9	77.2	88.2
% Change	7.8	-18.4	-3.8	-10.0	-20.2	-9.3	2.2	14.0	-23.3	-8.6	-13.5	4.5	14.2
5+ Family Units	455.7	463.7	403.3	357.3	363.7	368.0	394.4	407.1	576.2	545.8	397.0	399.8	456.6
% Change	-26.3	-24.6	-30.5	-32.8	-20.2	-20.6	-2.2	14.0	5.5	-5.3	-27.3	0.7	14.2
New Single-Family Home Sales (1000)	711	711	653	667	684	674	691	705	688	749	679	699	725
Percent Change -- Year Ago	-5.3	-9.9	-9.9	-2.8	-3.8	-5.2	5.8	5.7	7.7	8.9	-9.4	2.9	3.8
Mobile Homes Shipped (1000)	243	233	252	254	260	260	268	270	283	249	250	269	316
New Home Prices -- Median ($1000)	95.0	95.9	94.9	95.2	95.6	96.6	97.6	98.5	84.3	92.2	95.4	97.8	101.5
Percent Change -- Year Ago	10.0	9.0	3.6	3.1	0.6	0.3	2.1	2.7	5.4	9.4	3.5	2.5	3.8
New Home Prices -- ($1000, Quality Adj. to 1982)	93.6	97.1	97.3	98.4	98.8	99.5	100.9	102.3	92.4	94.9	97.9	101.2	104.7
Percent Change -- Year Ago	0.6	3.9	0.9	2.5	5.5				2.8	2.7	3.2	3.4	3.5
Existing Home Prices - Median ($1000)	79.4	83.9	82.2	83.1	84.2	84.9	86.0	86.5	75.5	80.3	83.4	86.2	89.8
Percent Change -- Year Ago	5.6	4.3	0.2	3.6	6.0	1.2	4.6	4.1	4.4	6.4	3.8	3.4	4.2
Mortgage Payment	529	530	592	579	566	566	554	562	631	559	566	560	557
Housing Affordability Index	109.3	110.7	101.5	105.5	108.5	109.9	116.2	116.1	94.8	105.7	106.6	114.1	115.3
Dollar Volume (billions)	364	372	338	350	363	369	383	389	291	355	356	386	424
FINANCIAL MARKETS													
Long-Term Interest Rates (%)													
30-year Fixed Rate Mortgage	9.4	8.8	10.3	9.9	9.5	9.4	9.0	9.1	12.2	9.9	9.6	9.1	8.6
1-year ARM (without buydown)	8.3	8.1	7.8	7.7	7.5	7.5	7.2	7.4	10.1	8.4	7.8	7.4	7.2
Corporate AAA Bond Rate	8.7	8.4	9.4	9.0	8.7	8.6	8.2	8.2	11.4	9.0	8.9	8.3	7.8
Government Bond Rate	7.5	7.5	8.6	8.2	7.9	7.6	7.4	7.3	10.8	7.8	8.1	7.4	7.2
Short-Term Interest Rates (%)													
Federal Funds Rate	6.3	6.2	6.3	6.3	6.3	6.4	6.5	6.7	8.1	6.8	6.3	6.6	7.1
3-month T-Bill Rate	5.4	5.5	5.7	5.5	5.5	5.4	5.5	5.7	7.5	6.0	5.6	5.6	6.0
Prime Rate	7.5	7.5	7.9	8.0	8.0	8.2	8.2	8.2	9.9	8.3	7.8	8.2	8.4
Discount Rate	5.5	5.5	5.5	5.5	5.6	5.8	5.9	5.9	7.7	6.3	5.5	5.9	6.2
Money Supply (M1)(% change)	18.2	13.6	5.5	6.7	6.1	6.8	6.8	7.1	9.1	13.3	12.1	6.6	6.2
Value of the U.S. Dollar (Trade-Weighted Avg.)	107.0	99.9	96.3	94.7	93.9	93.3	93.0	92.9	143.2	112.3	96.2	93.0	92.4
% Change	-4.8	-24.2	-13.5	-6.4	-3.5	-2.5	-1.3	-0.4	3.5	-21.6	-14.3	-3.3	-0.7

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Dr. Frederick Flick and Sean Burns.